BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Ken Nickolai	Commissioner
Phyllis A. Reha	Commissioner
Gregory Scott	Commissioner

In the Matter of a Petition by Interstate Power and Light Company for Authority to Increase Electric Rates in Minnesota

ISSUE DATE: April 5, 2004

DOCKET NO. E-001/GR-03-767

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER; ORDER MODIFYING SETTLEMENT

PROCEDURAL HISTORY

On May 19, 2003, Interstate Power and Light Company (IPL or the Company) filed a general rate case, proposing to increase its rates for electric service by approximately 8% or $4,973,766 annually. On June 5, 2003, the Company made a supplementary filing containing information required under earlier Commission Orders.

On July 17, 2003, the Commission issued three Orders taking the following actions:

- finding the Company's filing substantially complete as of June 5, 2003;
- suspending the proposed rates;
- setting interim rates;
- referring the case to the Office of Administrative Hearings for contested case proceedings.

There were two active parties to the case, the Company and the Minnesota Department of Commerce. The Residential and Small Business Utilities Division of the Office of the Attorney General filed a petition to intervene, which was granted, but the Division did not file testimony or briefs and did not otherwise participate.

The Company was represented by Michael Bradley, Moss & Barnett, P.A., 4800 Wells Fargo Center, 90 South Seventh Street, Minneapolis, Minnesota 55402.

The Department of Commerce (the Department) was represented by Ginny Zeller and Linda S. Jensen, Assistant Attorneys General, 1400 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101.

On November 5, 2003, an Administrative Law Judge held public hearings in the Company's assigned service area to take testimony from members of the public on the proposed rate increases. Those hearings were held in Albert Lea and Stewartville. Three members of the public attended, and two testified. Their testimony focused on the importance of the Company's economic development efforts to their communities. Also, five members of the public submitted written comments, all opposing any rate increase.

On November 18 and 19, 2003, the Administrative Law Judge held evidentiary hearings in the case in St. Paul.

On December 1, 2003, the Company and the Department entered into a Settlement and Stipulation, settling three issues: (1) the cost of capital, including the cost of equity; (2) the treatment of rate case expenses; and (3) the weather normalization method to be used in calculating test year sales and revenues.

On February 3, 2004, the Administrative Law Judge filed his Findings of Fact, Conclusions, and Recommended Order. On February 18, 2004, the parties filed exceptions to the Administrative Law Judge's Report.

On March 2, 2004, the Commission held oral argument, and the record closed under Minn. Stat. § 14.61, subd. 2. On March 4, 2004, the Commission met to deliberate and decide the case.

FINDINGS AND CONCLUSIONS

I. Summary of the Issues

As discussed above, the parties settled three issues – the cost of capital, the treatment of rate case expenses, and the weather normalization of sales volumes and revenues. They also took the same position on many issues, jointly submitting proposed findings, conclusions, and recommendations. Only eight issues were litigated before the Administrative Law Judge:

(1) the recoverability of administrative costs assessed by the Midwest Independent Transmission System Operator;

(2) the recoverability of the costs of safety studies conducted at an Iowa nuclear plant between 1994 and 1998;

(3) the recoverability of incentive compensation payments linked to the parent Company's earnings-per-share and the permissibility of using a tracker account for incentive compensation costs when no incentive compensation costs were incurred during the test year;

(4) the appropriateness of including in test year expenses unusually high pension costs and Other Post-Employment Benefit costs;

(5) the appropriate depreciation period for the Company's new information technology system, Enterprise Resource Planning;

(6) the advisability of deciding in this rate case whether the Company may in the future seek recovery from Minnesota ratepayers of nuclear decommissioning expenses allocated in this case to Iowa ratepayers, if the Iowa Utilities Board should reject that allocation and deny recovery;

(7) the appropriateness of continuing to offer non-peak/winter declining block rates for residential and single-phase farm customers;

(8) the appropriateness of the Company's proposal to limit the availability of Stored Heat service to customers currently taking that service.

In its exceptions to the Administrative Law Judge's Report, the Department removed issue 6 from the contested category, stating that it concurred with the Company and the Administrative Law Judge that the Commission should not decide in this case the consequences of potential future action by the Iowa Utilities Board. And at hearing the Department removed issue 8 from the contested category, clarifying that it had not filed exceptions on the Stored Heat service issue and did not intend to contest the Administrative Law Judge's recommendation.

II. The Legal Standard

Under the Public Utilities Act, companies seeking a rate increase have the burden of proof to show that the proposed rate change is just and reasonable. Minn. Stat. § 216B.16, subd. 4. Any doubt as to reasonableness is to be resolved in favor of the consumer. Minn. Stat. § 216B.03.

The Act also encourages settlements. Before beginning contested case proceedings on a general rate case, Administrative Law Judges are required to convene a settlement conference for the purpose of encouraging settlement of some or all of the issues in the case. They are authorized to reconvene the settlement conference at any point before the case is returned to the Commission, at their own discretion or at the request of any party. Minn. Stat. § 216B.16, subd. 1a (a).

The Commission is authorized to accept, reject, or modify any settlement. It can accept a settlement only upon finding that to do so is in the public interest and is supported by substantial evidence. Minn. Stat. § 216B.16, subd. 1a (b).

While the Commission recognizes that compromise is a key ingredient of any settlement, it also recognizes that resolving disputed issues in rate cases is fundamentally different from resolving disputes between private litigants:

> In deciding whether to accept the Offer of Settlement, the Commission must apply a different standard than is normally used by the courts. Unlike the traditional function of civil courts, the Commission's primary function is not to resolve disputes between litigants. Instead, it is an affirmative duty to protect the public interest by ensuring just and reasonable rates.
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> In the Matter of a Petition by the U.S. Department of Defense, the General Services Administration, and All Other Federal Executive Agencies of the United States Challenging the Reasonableness of the Rates Charged by Northwestern Bell Telephone Company, Docket No. P-421/CI-86-354, ORDER ACCEPTING OFFER OF SETTLEMENT (February 10, 1988) at 3.

Because rate case decisions can have far-reaching consequences for persons who were not at the negotiating table, the Commission has long required settling parties to document that all issues have been settled within the zone of regulatory reasonableness:

> In non-ratemaking settlement negotiations it is common for parties to concede some issues to obtain a more favorable resolution of others they value more highly. This is reasonable and appropriate in private disputes, where the goal of the settlement process is to reach a result satisfactory to all parties. In Commission proceedings, however, the goal of the process is to serve the public interest.
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> This requires protecting the interests of the Company, the public, and all customer classes, whether or not their interests are vigorously represented. It requires resolving every issue within the bounds of acceptable regulatory practice, since future rate structures are built on the foundations established in past rate cases. For these reasons the Commission scrutinizes settlements with care and requires documentation of the reasonableness of the disposition of all issues.
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> In the Matter of the Application of Interstate Power Company for Authority to Change its Rates for Natural Gas Service in the State of Minnesota, Docket No. G-001/GR-90-700, ORDER ACCEPTING AND ADOPTING STIPULATION AND OFFER OF SETTLEMENT (June 27, 1991), at 6-7.

III. Summary of Commission Action

The Commission will accept the settlement as to rate case expenses, weather normalization of test year sales and revenues, and three of the components of the cost of capital – capital structure ratios, the cost of long-term debt, and the cost of preferred stock. The Commission will not accept the parties' proposed 12.22% return on equity, finding that this rate of return is neither supported by substantial evidence in the record nor in the public interest.

The Commission will accept the Administrative Law Judge's findings on the other uncontested issues and will resolve the contested issues as set forth below.

These actions will be explained in turn.

IV. Settlement Accepted as Modified

The Commission accepts the weather-normalization methodology proposed by the parties, finding that it is just and reasonable, supported by substantial evidence, and in the public interest.

The Commission accepts the parties' agreement as to rate case expenses, subject to reexamining the issue on reconsideration. The negotiated cap on rate case expenses for the next case is reasonable, particularly in light of the short time frame between this case and the projected filing date for the next one.

At this point the dollar amounts slated for recovery for expenses incurred in this case also appear to be just and reasonable, supported by substantial evidence, and in the public interest. This determination could change, however, should the ultimate rate impact of this proceeding prove to be negligible, raising issues of prudence and reasonableness as to rate case expenses.

The Commission also accepts the parties' settlement on the issues of capital structure ratios, the cost of long-term debt, and the cost of preferred stock. Their resolution of these issues is supported by substantial evidence, is just and reasonable, and is in the public interest. The Commission will, however, modify the settlement's 12.22% return on equity, finding that it is neither supported by substantial evidence nor in the public interest. The Commission will instead set the return on equity at 11%, based on record evidence.

V. Return on Equity

A. Background

Unlike the cost of long-term debt or preferred stock, the cost of common equity cannot be measured directly, but must be inferred from market data. IPL, as a wholly-owned subsidiary of Alliant, does not trade on the market. Therefore, in order to estimate the cost of equity to IPL, it is necessary to estimate the cost of equity for companies that present similar investment risks.

The Company presented studies using two groups of companies: five electric companies in one group, and three combination electric and gas companies in the other. The Department used a single group of five electric companies. Their analytical processes are described below.

1. IPL's Position

IPL studied the cost of equity for its two groups using the following approaches: DCF (Discounted Cash Flow), RPM (Risk Premium), Traditional CAPM (Capital Asset Pricing Model), Empirical CAPM, Average CAPM (which summarizes the Traditional CAPM and the Empirical CAPM), and Comparable Earnings. The approaches and their results are summarized in the table below:

Type of Study	Electric Group	Combination Group
DCF	11.3%	10.4%
Risk Premium (RPM)	12.4%	12.3%
Traditional CAPM	11.6%	11.2%
Empirical CAPM	12.4%	12.1%
Average CAPM (Average of Traditional and Empirical)	12.0%	11.7%
Comparable Earnings	12.9%	13.0%

The IPL witness testified that his best estimate of the cost of equity for the group of five electric companies was 12.00%, based on these studies. For the group of three combination companies, the best estimate was 11.50%.

IPL's witness then adjusted these estimates upward, based upon two factors: (1) his understanding that "[i]t is well established in the financial literature, and well noted by investors, that the size of an enterprise affects the level of its business risk";[1] and (2) an Ibbotson Associates 2002 study showing that historically firms with smaller capitalizations have had higher returns than firms with larger capitalizations.[2] IPL's witness added 60 basis points to the equity cost estimate of the electric utility group, as the group's average capitalization exceeded that of IPL by 5.1 times. He added 45 basis points to the estimate of the combination company group, that was, on average, 3.5 times as large as IPL.[3]

He concluded that the cost of equity to IPL was in the range of 12.0% to 12.6%, and recommended that the Commission allow IPL 12.3%.

2. The Department's Position

The Department submitted a DCF (Discounted Cash Flow) study of the cost of equity of five electric companies comparable to IPL. The study yielded a "reasonable range" for the group of 9.59% to 11.91%, with a "best point estimate" of 10.76%.

Instead of basing its calculations on the best point estimate, however, the Department adjusted that number upward by 5% to reflect the cost of issuing securities, often called a "flotation adjustment." This brought the reasonable range to 9.90% to 12.22%.[4] The Department then set its recommended return at the highest point of the range, 12.22%, to reflect IPL's smaller size vis-a-vis the rest of the companies in the group, explaining that "All other factors the same, a smaller company has higher investment risk."[5]

3. The Recommendation of the Administrative Law Judge

The Administrative Law Judge found that the parties' settlement was supported by substantial evidence in the record and that the record did not support rejection of either a size or an issuance adjustment to the base cost of equity. He recommended adopting the 12.22% return on equity proposed by the parties.

The Administrative Law Judge took a cautious approach to the Ibbotson study, finding only that for purposes of this case it was appropriate to accept its principal conclusion, that the size of a firm is a factor in determining risk and return:

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[1] Direct Testimony of Frank J. Hanley, p. 7.

[2] Id., p. 10.

[3] Id., p. 8.

[4] Direct Testimony of Steve Rakow, p. 21.

[5] Id., p. 22.

> The Administrative Law Judge takes comfort from the fact that Ibbotson Associates is a widely-recognized statistical reporting firm that has a national reputation. He considers it to be in the same general category as Standard & Poor's or Moody's. There is no indication that the report in question was prepared for IPL, or the utility industry, to bolster arguments in rate cases. Instead, it appears that the report in question is part of an almanac-type yearbook that Ibbotson prepares without any particular focus on the utility industry. The Administrative Law Judge understands and shares the concerns of the Staff concerning the methodology used, and thinks the issue is worthy of pursuit in some other forum. But for purposes of this case, the Administrative Law Judge accepts the principal conclusion of the study – that size of a firm is a factor in determining risk and return.[6]

B. Summary of Commission Action

The Commission will modify the settlement to set the return on equity at 11%, finding that the 12.22% number is not supported by substantial evidence, is not just and reasonable, and is not in the public interest. In making this determination the Commission is guided by the statutory requirement that it resolve all doubts as to the reasonableness of any rate in favor of the consumer.[7]

In brief, the Commission rejects the 12.22% return for the following reasons, which will be explained below:

- The flotation adjustment applied by the Department was not requested by the Company, is inconsistent with Commission precedent, has no support in the record, and cannot be justified as a just and reasonable rate component.

- The size adjustments applied by the Company and the Department are much too large to justify on this record, which not only does not contain empirical data demonstrating IPL's susceptibility to size-related risk but also fails to examine and account for other business and investment risks that may offset or even outweigh the risk associated with the Company's size.

- It would be anomalous to set Interstate's return on equity at its highest rate in the past 13 years, at a time when the cost of money is at its lowest point in some 40 years.

The Commission finds that the record and the public interest support an 11% return on equity. That finding, which will be explained more fully below, is based on the fully developed, factually-supported DCF studies placed in the record by both the Department and the Company, and on a smaller, more reasonable adjustment for IPL's size.

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[6] Administrative Law Judge's Report, Finding 78.

[7] Minn. Stat. § 216B.03.

C. The Flotation Adjustment Must Be Rejected as Unrequested by the Company and Unsupported in the Record.

The Department added a 30-basis-point "flotation adjustment" to its baseline return on equity to reflect the cost of issuing securities. The Company did not request a flotation adjustment.

IPL, as a wholly-owned subsidiary of Alliant Energy, does not issue its own securities to the public and therefore has no issuance costs. Alliant Energy owns all of IPL's stock and issues securities to meet the capital needs of all parts of its operation, including IPL's regulated utility operations. There is nothing in the record indicating that Alliant expects to incur costs for securities issuances during the test year or in the near to intermediate term. There is nothing in the record permitting even a ballpark estimate of what portion of any future Alliant securities issuance might be driven by IPL's needs.

The Commission has as a general practice rejected flotation adjustments in the absence of tangible evidence on actual securities issuances and their costs. In the 1991 Midwest Gas rate case, for example, both the Commission and the Administrative Law Judge rejected the Department's inclusion of flotation costs in return on equity because there was no factual demonstration that such costs would be incurred:

> The other reason the Commission has not adopted Dr. Amit's testimony is his inclusion of a flotation cost adjustment for issuance of stock. In this case, as noted by the ALJ, Midwest Gas has failed to affirmatively establish facts that support a flotation cost adjustment.[8]

Similarly, in the 1995 Minnegasco rate case, the Commission concurred with the Administrative Law Judge in denying a proposed flotation adjustment based on an insufficient factual showing:

> Finally, the Commission rejects the Company's recommendation to add a flotation cost adjustment of 0.22 percent to the Department's required return on equity estimate. The Commission finds that the Company failed to demonstrate that a flotation cost was necessary and did not calculate a specific flotation cost adjustment for its own recommendation. In addition, the record did not contain evidence with respect to actual or projected issuance costs incurred by the Company.[9]

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[8] *In the Matter of the Application of Midwest Gas, a Division of Iowa Public Service Company, for Authority to Change Its Schedule of Gas Rates for Retail Customers within the State of Minnesota*, Docket No. G-010/GR-90-678, Findings of Fact, Conclusions of Law, and Order (July 12, 1991), at 27.

[9] *In the Matter of the Application of Minnegasco, a Division of NorAm Energy Corp., for Authority to Increase Its Natural Gas Rates in Minnesota*, Docket No. G-008/GR-95-700, Findings of Fact, Conclusions of Law, and Order (June 10, 1996), at 46.

Here, too, the record is devoid of any factual basis for granting a flotation adjustment, and it will be denied.

D. The Parties' Size Adjustments Must Be Rejected As Excessive, Unreasonable, and Not Supported by Substantial Evidence.

Both the Department and the Company recommended significant increases in return on equity to reflect the Company's smaller size vis-a-vis the other companies in the comparison groups. (The other companies in the Department's comparison group were on average 3.3 times the size of IPL; those in the Company's comparison groups were on average 5.1 and 3.5 times that size.)

The Department adjusted for size by setting its recommended rate of return at the very highest number that its study placed within the range of reasonableness. The Company adjusted for size by adding 45 to 60 basis points to base rates of return derived from a set of studies whose methodologies – with one exception – the Commission has consistently refused to credit with primary weight in setting rates of return. That exception is the DCF method, which is discussed below.

The Department based its size adjustment on basic financial theory, which, it explained, holds that, other factors being equal, smaller companies face higher risks, mainly because they have less ability to absorb the effects of adverse financial events.[10] The Company based its size adjustment on the same theory, attributing it to the financial literature, and on an Ibbotson Associates study showing that, historically, firms with smaller capitalizations have had higher returns than firms with larger capitalizations.[11]

The Commission has no quibble with basic financial theory. It has long taken company size into account in setting both debt/equity ratios and rates of return on equity;[12] it will continue to do so; and it will make an upward adjustment in this case based on company size. The adjustments proposed by the Company and Department, however, are excessive, given the absence of record evidence that IPL's size exerts extraordinary influence over its business or investment risk.

Size, after all, is only one of many factors affecting risk. Other factors traditionally evaluated in the electric utility context include the relative proportion of industrial and residential ratepayers in the customer base, the financial stability of very large customers, the economic health of the service area and its likely impact on demand for electricity, the utility's potential exposure to liabilities related to nuclear operations, the utility's debt/equity ratio, the utility's embedded cost of long-term debt, and the general state of the utility's infrastructure and its need for new facilities.

None of these factors were evaluated in this record, and all have the potential to affect risk as decisively as the Company's size. All but nuclear liability exposure also have the potential to offset any risks resulting from the Company's size. The parties' focus on size, to the exclusion of all other risk-affecting factors, appears arbitrary, unreasonable, and incapable of supporting an upward adjustment of the magnitude recommended.

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[10] Transcript of Evidentiary Hearings, volume 2, pp. 57-58.

[11] Id., Exhibit FJH -1 , p. 17.

[12] E.g., *In the Matter of the Application of Midwest Gas*, Docket No. G-010/GR-90-678.

Furthermore, there is a non-traditional risk factor that should have been evaluated in this case, and was not – the percentage of company operations devoted to providing regulated utility service. IPL has no non-utility operations. Most of the companies in the comparison groups do, including such wide-ranging ventures as fiber optics, internet services, close-tolerance, custom manufacturing, and energy marketing.[13]

Non-utility operations have clearly emerged as a significant risk factor over the past few years, with many utilities suffering significant losses from these operations and many seeking to shed their non-utility operations to return to their core utility business. IPL's lack of non-utility operations could well offset much, if not all, of any additional business risk resulting from its relatively small size.

And finally, while size may be a significant predictor of risk in the general world of commerce, its influence is clearly less pronounced in the utility context. Utilities, after all, sell essential services to captive customers at prices explicitly designed to provide a reasonable profit. Small utilities do not have to compete against large utilities – they have exclusive, assigned service areas. Their customers cannot readily forgo using their product or substitute another product for it. Their customers cannot choose to take their business elsewhere.

These are major differences between utilities and the companies treated in the financial literature and between utilities and the companies featured in the Ibbotson study. These major differences clearly make it unreasonable to reflexively attribute the same risk to size in the utility context that the literature and the Ibbotson study may suggest is appropriate in the general commercial context.

For all these reasons, the Commission concludes that it must reject the size adjustments proposed by the parties as excessive, unreasonable, unsupported by substantial evidence, and not in the public interest.

E. The Proposed 12.22% Return is Anomalous in Relation to Past Practice and Current Economic Conditions

Determining the cost of equity is an extremely context-specific task. Equity costs vary significantly with the state of the national, regional, and local economies, as well as with the unique characteristics of each utility, its customer base, and its service area. For these reasons, the Commission approaches the rate of return portion of each rate case as a thoroughgoing review of all the factors that affect the financial, business, and investment risk of the utility. Past rates of return and the rates of return of other utilities carry less weight in this analysis than the factors listed above.

Even so, the Commission cannot help but note that the 12.22% return on equity proposed by the parties is significantly out of alignment with past returns set for this Company during periods when the cost of money was higher than it is at present. For the past 13 years, IPL's return on equity has ranged from the 10.9% set in its 1991 rate case to the 11% set in its 1995 rate case and in effect today.

[13] Transcript of Evidentiary Hearings, volume 2, pp. 40-48.

Meanwhile, there has been no documented upward movement in factors affecting the Company's business or investment risk, and there has been downward movement in two recognized risk factors – debt/equity ratio and the embedded cost of long-term debt. Further, the cost of money has dropped to essentially the lowest point in some 40 years.

While these considerations alone would not have led the Commission to reject the parties' proposed return on equity, they do serve to confirm the overall conclusion that 12.22% is an excessive return on equity.

F. 11% Return on Equity Adopted

The Commission finds that the most reasonable return on equity supported by this record is 11% and will set the return on equity at that level. This rate of return results from averaging the "best point" return from the Company's DCF studies and the "best point" return from the Department's DCF study and then making an upward adjustment to reflect both IPL's relatively small size and the existence of three credible DCF studies.

The Commission uses the DCF studies in the record as its starting point for three reasons. First, there are *three* fully developed DCF studies in the record, providing the valuable opportunity to check each study's results and methodology against the other's. Second, the three studies have yielded extremely similar results, providing a high level of confidence that none of the studies are seriously flawed due to error or bias. Third, the DCF method is a method that this Commission has long and consistently favored in setting rates of return on equity. In fact, the Commission has relied primarily on DCF studies in nearly every rate case since 1978, when it began regulating gas and electric utilities.

In IPL's last rate case, the Commission explained its longstanding and heavy reliance on DCF studies in setting returns on equity, again concurring with the Administrative Law Judge:

> The ALJ recommended that the Commission adopt Dr. Thompson's analysis.
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> He found that translating Interstate's risk into a just and reasonable return on equity requires an analysis which incorporates both its current yield and expected growth as well as an analysis of companies whose risk is comparable to that of Interstate. The ALJ noted that, while no one method of analysis is necessarily required, the discounted cash flow (DCF) method is generally considered to be the most basic and fair approach for regulatory purposes. He said it produces reasonable, consistent and fair estimates of the cost of common equity. He said the DCF model is basic to modern financial theory and provides objective information concerning the cost of common equity capital in the expected regulatory period.
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> The ALJ noted that the Minnesota Commission has consistently utilized the DCF method in making its determinations of the appropriate rates of return for Minnesota utilities. He quoted the Commission's Order in Interstate's last electric rate case: "The DCF method is firmly grounded in modern financial theory, and has been recommended by the Department and the RUD-OAG in this proceeding and by this Commission in nearly every case decided since 1978." Findings of Fact, Conclusions of Law and Order, Interstate Power Co., Docket No. E-001/GR-91-605 (1992), pp. 34-35.

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> As it has in the past, the Commission finds the standard DCF analysis to produce reasonable, consistent, and fair estimates of the cost of equity. Dr. Thompson's application of it here, as the ALJ found, produces a cost of equity estimate that is fair both to investors and ratepayers.[14]

The DCF method has repeatedly demonstrated its ability to establish an empirically and analytically sound range of reasonable returns on equity. It is a proven quantity and a trustworthy tool. The Commission will therefore use the DCF studies in the record as its starting point in determining Interstate's cost of equity.

Averaging the "best point" returns on equity of the two DCF studies in the record yields a return on equity of 10.80%. Instead of setting the cost of equity at this point, however, the Commission will make an upward adjustment to bring the cost of equity to the Company's current level, 11%, for two reasons.

First, 11% falls in the middle of the "reasonable range" created by placing the "reasonable ranges" identified by the Department's and the Company's DCF studies on a continuum. When placed on a continuum, the reasonable ranges of the three studies overlap, creating a joint "reasonable range" of 10.4% to 11.3%. The 11% return falls near the midpoint of that range, whereas the 10.80% average of the three studies' "best points" falls at its lower border. Setting the cost of equity at the lower border gives the Commission pause, since the record does not demonstrate that the Company's risk level is lower than average, nor does it contain cross-examination or similar testimony demonstrating that the Department's DCF study – and its lower reasonable range – are clearly superior to the Company's.

Second, the Commission concurs with the Administrative Law Judge in his conclusion that, whatever the merits and applicability of the Ibbotson study, for purposes of this case, it is reasonable to accept its principal conclusion – that the size of a firm is a factor in determining risk and return."[15] The size of a firm *is* a factor – not the only factor, usually not the main factor, but *a* factor – in determining return on equity, and setting Interstate's return on equity above the lower border of the joint reasonable range is a reasonable adjustment for size, given the state of this record.

While neither of these two factors may by itself have met the statutory standard that all doubts as to reasonableness must be resolved in favor of the consumer,[16] together they meet that standard and together justify setting the return on equity above the lower border of the joint reasonable range defined by the two DCF studies.

For all the reasons set forth above, the Commission sets the return on equity required by Interstate at 11%. The overall rate of return for IPL is 9.054%, calculated as follows:

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[14] *In the Matter of the Request of Interstate Power Company for Authority to Change Its Rates for Electric Service in Minnesota*, Docket No. E-001/GR-95-601, Findings of Fact, Conclusions of Law, and Order (April 8, 1996), at 27-28.

[15] Administrative Law Judge's Report, p. 19.

[16] Minn. Stat. § 216B.03.

Type of Capital	Ratio	Cost	Weighted Cost
Long-Term Debt	45.155%	7.084%	3.199%
Preferred Stock	7.697%	8.688%	0.669%
Common Equity	47.148%	**11.000%**	5.186%
Overall ROR	100.000%		**9.054%**

VI. The Contested Issues

A. MISO Schedule 10 Administrative Expenses

1. Background

On May 9, 2002, the Commission issued an Order granting the Company's request to transfer operating control of most of its transmission facilities to the Midwest Independent System Operator, Inc. (MISO), a regional transmission organization.[17] Regional transmission organizations serve as neutral, third-party administrators of utilities' transmission facilities. These organizations have grown up in response to federal policies requiring utilities that own, operate, or control interstate transmission facilities to make those facilities available to all comers on a nondiscriminatory, first-come, first-served basis,[18] primarily for the purpose of promoting broader, freer, more efficient markets for wholesale power.

In its first Order requiring open access to the national transmission system, the Federal Energy Regulatory Commission (FERC) pointed to regional transmission organizations (RTOs) as promising vehicles for implementing the requirements of open access.[19] Then, in 1999, FERC

[17] *In the Matter of Interstate Power Company's Petition for Approval of Transfer of Operational Control of Transmission Facilities to the Midwest Independent System Operator*, Docket No. E-001/PA-01-1501, Order Authorizing Transfer with Conditions (May 9, 2002), hereinafter *MISO Order*.

[18] There are some narrow exceptions for facilities necessary to serve the utility's own retail customers.

[19] *See* generally *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmission Utilities*, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Statutes and Regulations, Regulations Preambles January 1991 - June 1996 ¶ 31,036 (1996), *order on reh'g,* Order No. 888-A, 62 Fed. Reg. 12,274 (1997), FERC Stats. & Regs ¶ 31,048 (1997), *order on reh'g,* Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g,* Order No. 888-C, 82 FERC ¶ 61,046 (1998), ("Order 888"), Part III ("Background"); *New York v. FERC*, 2002 WL 331835 (U.S., March 4, 2002).

issued an Order requiring each public utility that owns, operates, or controls interstate transmission facilities to file either a proposal to join an RTO or an explanation as to why it was not joining an RTO.[20]

In response to that Order, Interstate Power Company, IPL's predecessor, filed a petition with this Commission seeking authority to transfer operating control over most of its transmission facilities to MISO. The Company – and the other three utilities filing similar petitions – recognized that surrendering control of their transmission facilities could have far-reaching consequences, including dramatically reducing their control over their transmission costs. (MISO would bill its members for administrative costs and investments under its Open Access Transmission Tariff, Schedule 10. Those costs were undetermined at the time the petition was filed.)

The utilities knew that this would raise concerns among regulators. They therefore entered into negotiations with the Department of Commerce (the Department) and the Residential and Small Business Utilities Division of the Office of the Attorney General (RUD-OAG), the two public agencies that represent the public interest in Commission proceedings, seeking to establish a set of conditions that would permit these agencies to support MISO membership by the utilities.

What emerged from these negotiations was a comprehensive set of ratepayer protections, including the utilities' acknowledgment of the Commission's ongoing jurisdiction over their MISO participation; reporting requirements on post-transfer service reliability; procedures for prompt and complete sharing of information about MISO issues with regulators; and ground rules for cost recovery. These ground rules included two limitations: (1) MISO Schedule 10 costs could be recovered only in the context of a full-blown rate proceeding, unless otherwise ordered by the Commission; and (2) no party could use any Commission Order permitting utilities to join MISO as evidence that the costs of membership were reasonable or should be recovered from ratepayers.

The Commission accepted and adopted the ratepayer protections jointly proposed by the utilities and the public agencies. Relevant portions of the Interstate Order applicable to the cost recovery issue in this case read as follows:

> The public agencies recommend that the Commission clarify the rate-making consequence of this docket. Specifically, they ask the Commission to find that it is not making a determination as to the reasonableness of any costs IPC [now, IPL] may seek to recover from retail customers associated with the transfer of operational control of its transmission facilities to the MISO, MISO operation of those facilities, the services taken from the MISO by IPC, or IPC's MISO membership. They also recommend that the Commission declare that no party may use the Commission's decision in this matter as evidence of reasonableness in any later proceeding regarding whether MISO-related costs or rates should be recovered in IPC's retail rates.

[20] *Regional Transmission Organizations,* 65 Fed. Reg. 809 (January 6, 2000), FERC Stats. & Regs. ¶ 31,089 (1999), order on reh'g, Order No. 2000-A, 65 Fed. Reg. 12,088 (March 8, 2000), FERC Stats. & Regs. ¶ 31,092 (2000), *aff'd sub nom.* Public Utility District No. 1 of Snohomish County, Washington v. FERC, Nos. 00-1174, *et al.* (D.C. Cir. 2001).

IPC agrees to these recommendations, and no party opposed them. The Commission finds these recommendations reasonable, and will adopt them.

MISO Order at 12.

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. . . IPC is willing to agree to seek recovery of certain MISO-related costs only through a rate proceeding, where the Commission can consider the costs' reasonableness and prudence before deciding whether to pass the cost on to consumers. In so doing, IPC attests to the good faith with which the proposal was made and provides the strongest evidence of the proposal's reasonableness.

MISO Order at 12,

2. Positions of the Parties

a. The Company

The Company sought to include in test year expenses $228,965 in administrative costs paid to MISO under its Schedule 10 tariff. (The Company chose not to litigate the rate-recoverability of some smaller MISO-related fees listed in its initial petition.) The Company contended that the benefits of MISO membership were just beginning to materialize, but that in time they would include the following:

- A more liquid and efficient wholesale energy supply market.
- More effective network security.
- Enhanced system reliability.
- A simplified, more user-friendly set of procedures and charges for transmission access.

The Company stated that it was impossible to compare transmission costs under the MISO regime with pre-MISO transmission costs and introduced no evidence going to that issue.

The Company emphasized that MISO was in start-up mode and that it was tackling a set of extremely diverse and complex tasks previously performed by numerous utilities and two regional entities (the Mid-Continent Area Power Pool and the Mid-American Interconnected Network). Under these circumstances, the Company, argued, it was unreasonable to expect concrete ratepayer benefits at this stage in MISO's organizational development.

Finally, the Company also argued that disallowing rate recovery of MISO costs would penalize IPL for complying in good faith with federal policy.

b. The Department

The Department opposed rate recovery of MISO Schedule 10 costs, with the exception of the $26,167 the Company saved in payments to the Mid-American Interconnected Network for services now performed by MISO. The Department stated that none of the other Schedule 10 costs had been shown to provide current benefits to Minnesota ratepayers and that any future benefits were speculative at this point.

The Department emphasized that MISO membership was voluntary. It also emphasized that the Commission had permitted the Company to transfer control of its transmission facilities to MISO only with the assurance that MISO administrative costs would receive careful review as to prudence, reasonableness, and accuracy before being assessed against ratepayers.

Finally, while continuing to advocate the disallowance of these costs, the Department offered the alternative of deferring their potential recovery to the next rate case, when the benefits of MISO participation would presumably be clearer.

3. The Recommendation of the Administrative Law Judge

The Administrative Law Judge found that "the only *documented and quantified* savings attributable to the Company's participation in MISO is $26,167, which represents Minnesota's share of the Company's prior payments to MAIN (Mid America Interconnected Network) for services that were assumed by MISO."[21]

He found that MISO was providing, or beginning to provide, a number of other benefits, but that their value had not been quantified in the record. The most concrete of these was the elimination of "pancaking," the former practice of each transmission owner charging for access to its portion of the transmission system. Now, of course, there is a single, uniform fee for transmission services within the MISO footprint.[22]

Other current, evolving, or future benefits cited by the Administrative Law Judge included the elimination of discriminatory transmission pricing and access; regional coordination of transmission planning, which presumably improves system reliability and market efficiency; and technical management of the grid, including loopflow and seams management.[23]

The Administrative Law Judge concluded that, with the exception of the avoided MAIN costs discussed earlier, the Company had not demonstrated enough ratepayer benefit to justify including MISO Schedule 10 administrative costs in IPL's revenue requirement. Because of MISO's promise, its start-up status, and federal policies strongly favoring utility membership in RTOs, however, he recommended granting deferred accounting treatment and giving IPL another chance, in its next rate case, to establish that these costs produced benefits for ratepayers and should be built into the rate structure.

4. Commission Action

The Commission concurs with the Administrative Law Judge that IPL has failed to prove by a preponderance of the evidence the reasonableness and prudence of all but $26,167 of its Schedule 10 administrative costs. The Commission concurs with the Administrative Law Judge that rate recovery is not currently permissible. The Commission respectfully disagrees, however, with the

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[21] Administrative Law Judge's Report, Finding 10, emphasis in original.

[22] Administrative Law Judge's Report, Finding 18.

[23] Administrative Law Judge's Report, Finding 18.

Administrative Law Judge's recommendation to grant deferred accounting treatment, believing that such treatment is inconsistent with both past regulatory practice and best regulatory practice. These decisions are explained more fully below.

a. Reasonableness and Prudence Not Proven by Preponderance of the Evidence

As the Commission's Order approving IPL's petition to join MISO demonstrates, the Commission was extremely concerned at that time about MISO's potential cost to Minnesota consumers and about MISO's structurally low level of accountability to Minnesota utilities, ratepayers, and regulators. IPL agreed to provide quarterly MISO updates to regulators and represented that it expected MISO-related reductions in the cost of wholesale power to offset any MISO-related increases in the cost of transmission.[24]

In its rate case filing, however, the Company provided no evidence of reductions in the cost of wholesale power and no evidence of reductions in the cost of transmission, with the exception of the $26,167 savings in MAIN fees. It provided no pre-MISO and post-MISO transmission cost comparisons, saying that MISO had so fundamentally changed the regional power market that such comparisons were impossible. It provided no pre-MISO and post-MISO wholesale power cost comparisons, for the same reason.[25]

Instead, the Company essentially listed the same goals it had cited in its petition for authority to join MISO, such as a more liquid and efficient wholesale energy supply market, more effective network security through regional coordination, enhanced system reliability through regional transmission planning, and fairer, more efficient transmission access procedures. It stated that achieving these goals would benefit Minnesota ratepayers. It stated that MISO was pursuing these goals with good progress. It contended that it was unreasonable to expect MISO, as a start-up entity, to demonstrate measurable progress in these areas or to attach monetary values to its accomplishments.

The Commission disagrees. Its *MISO Order* clearly demonstrated its unwillingness to rely on generalizations in deciding cost recovery issues; that is why it emphasized that those issues should be resolved in full-blown rate proceedings, which present the opportunity to "consider both increasing *and decreasing* costs, and to evaluate the accuracy, prudence and reasonableness of those costs."[26] However worthwhile MISO's goals may be, in the absence of evidence that the cost of pursuing and attaining them is reasonable and prudent in relation to their benefit to Minnesota ratepayers, rate recovery must be denied.

IPL is unable to attach any credible monetary value to the services it receives from MISO. It states that it cannot compare MISO costs with those it incurred for similar services before it joined MISO. It states that it cannot compare its pre-MISO and post-MISO wholesale power costs, the

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[24] *MISO Order* at 6.

[25] IPL Post-Hearing Brief, p. 8.

[26] *MISO Order* at 10.

one cost area in which it expected savings to result from MISO membership. It does not even provide an estimate of cost savings resulting from the elimination of "pancaking," the one MISO benefit that is concrete, already achieved, and presumably quantifiable.

The Commission must conclude from this that IPL has not proved by a preponderance of the evidence that its MISO Schedule 10 costs, with the $26,167 exception, have been reasonably and prudently incurred for the benefit of ratepayers.

b. Deferred Accounting Inappropriate

The Commission respectfully disagrees with the Administrative Law Judge's conclusion that deferred accounting treatment would be appropriate for these expenses.

Deferred accounting is a valuable regulatory tool used primarily to hold utilities harmless when they incur out-of-test-year expenses that, because of their nature or size, should be eligible for rate recovery as a matter of public policy. Traditionally, deferred accounting was reserved for costs that were unusual, unforeseeable, and large enough to have a significant impact on the utility's financial condition.[27] More recently, deferred accounting has been permitted when utilities have incurred sizeable expenses to meet important public policy mandates, such as the farm tap inspection program required by the Commission.[28]

Deferred accounting is not generally used, however, to give utilities a second chance to prove up the prudence and reasonableness of costs that they were unable to prove up on their first attempt. Nor is it generally used to preserve for later potential rate recovery, costs whose prudence and reasonableness were judged doubtful on initial examination. There are three main reasons for this.

First, re-litigating rate recovery issues by deferring them to later rate cases is administratively inefficient. It forces parties to re-develop and re-address issues they have developed and addressed in earlier proceedings, which is inefficient on its face. And it insidiously reduces efficiency by reducing incentives for effective advocacy and exhaustive analysis the first time an issue is addressed.

Second, deferring costs is very expensive for ratepayers, since deferred costs accrue interest while deferred. Third, deferring costs works at cross purposes with the regulatory principle of "inter-generational equity," the concept that regulators should strive to match as closely as possible the set of ratepayers who benefit from an investment or expenditure with the set of ratepayers who pay for it in rates.

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[27] *In the Matter of the Application of Northern States Power Company Gas Utility for Approval of Deferred Accounting for Certain Manufactured Gas Plant Site Cleanup Costs*, Docket No. G-002/M-94-104, Order Granting Request for Deferred Accounting (September 6, 1994).

[28] *In the Matter of Peoples Natural Gas Company's Request to Establish a Tariff for Repairing and Replacing Farm Tap Lines*, Docket No. G-011/M-91-989, Order Permitting Company to Continue Deferred Accounting (February 17, 1998).

For all these reasons, deferred accounting is not a favored ratemaking tool, but an exceptional remedy reserved for situations that otherwise threaten grave inequity or serious public policy failure. The MISO Schedule 10 costs at issue do not present those risks, and the most reasonable regulatory response to the Company's inability to demonstrate their reasonableness and prudence by a preponderance of the evidence is to disallow rate recovery.

Finally, the Commission rejects the claim that it must or should build these costs into rates on grounds that they were incurred as part of IPL's participation in a federal energy policy initiative. The Commission concurs with the federal appeals court ruling in *Public Utility District No. 1 of Snohomish Count*, *Washington v. FERC* that RTO membership is entirely voluntary.[29] Costs incurred voluntarily are subject to the normal standards of reasonableness and prudence review, with all doubts as to reasonableness resolved in favor of the consumer under Minn. Stat. § 216B.03.

B. Incentive Compensation

1. Positions of the Parties

a. IPL

The Company requested that it recover costs for incentive compensation plans it has established for various level of employees. In these plans the payment of the incentive compensation was not guaranteed. Rather, the incentive compensation payment was tied to performance of pre-established goals, including some that relate directly to IPL and some that relate to IPL's parent, Alliant Energy (Alliant). One of the specific requirements for an incentive compensation payment to an IPL employee was that Alliant's earnings must meet a certain minimum level.

Incentive compensation was paid in three of the last five years, but one of the years that it was not paid was the 2002 test year period. Incentive compensation was not paid in the 2002 test year because of overall poor earnings of Alliant, IPL's parent company, even though IPL itself showed an increase in pretax operating income in 2002 over 2001.

In response to concern that the incentive compensation payments might not actually be made during the time that the rates are in effect, IPL proposed that a five-year average of its incentive compensation payments be included in rates. IPL also proposed that any amounts included in rates but not paid would be refunded to the ratepayers.

The Company argued that this proposal was in line with the Commission's requirement in Northern States Power Company's (NSP) most recent electric rate case that NSP track and refund any amounts included in rates but not paid to ensure that ratepayers did not pay for incentive compensation that did not actually occur.[30]

[29] *Public Utility District No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

[30] *In the Matter of the Application of Northern States Power Company for Authority to Increase its Rates for Electric Service in the State of Minnesota*, Docket No. E-002/GR-92-1185, ORDER AFTER RECONSIDERATION (January 14, 1994).

IPL argued that an earnings-per-share trigger helped to make the Company's stock offerings competitive. It argued that this was a direct benefit to ratepayers because IPL would be better able to obtain and retain the capital it needed from Alliant.

2. DOC

The DOC argued that the Company did not establish that the expense should be included in the test year and the performance criteria and purpose of the incentive plan were not consistent with the interests of ratepayers.

The Company had no incentive compensation plan payments in the test year. The Company proposed that the expenses for incentive awards that the Company had budgeted to make in 2003 be included in the test year expenses. The DOC argued that it would be speculative to assume there would be an incentive award booked in 2003 and subsequent years, when there had been no incentive payments made in 2002, nor in two of the last five years. For this reason, the DOC argued that the incentive plan expenses should be disallowed.

The DOC stated that in IPL's incentive compensation plan employee performance directly related to IPL would not be sufficient to trigger an incentive payment. Rather, incentive payouts would only be made if the parent company, Alliant, met specified earning thresholds. The DOC argued that ratepayers should not pay for an employee benefit that is not related to the operation or performance of the regulated utility.

Further, the DOC argued that because the incentive plan expense is a function of Alliant's earnings-per-share performance, the plan increases shareholder wealth at the expense of the ratepayer.

The DOC also argued that allowance of the incentive plan expense is inconsistent with past decisions of the Commission. The DOC stated that its review of the NSP 1991 rate case[31] indicated that the Commission disallowed recovery of incentive compensation from ratepayers because the NSP incentive compensation, like the IPL compensation herein, might not be paid even though an employee individually met performance goals, if the company as a whole failed to achieve earnings-per-share targets. The DOC argued that the incentive compensation plan disapproved in the 1991 NSP rate case was identical in relevant detail to the IPL incentive compensation plan herein. It further argued that the ALJ's recommendation is inconsistent with this rate case and should not be adopted.

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[31] *In the Matter of the Application of the of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota,* Docket No. E-002/GR-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991).

The DOC argued that the ALJ's recommendation was also inconsistent with the Commission's action in the NSP 1992 electric rate case.[32] The Commission, in the 1992 rate case, indicated that it continued to consider an earnings per share threshold an improper transfer of risk. However, in the 1992 case, because NSP indicated that it did not seek to recover for incentive compensation based on the earnings-per-share threshold, the Commission did allow recovery for the incentive compensation for management employees, subject to certain conditions.

2. The ALJ's Recommendation

The ALJ found that IPL's incentive compensation plan has several benefits to the Company and to ratepayers including: 1) it allows the Company to attract and retain reliable and well-trained people, 2) the incentive compensation plan allows the Company to decrease employee base pay which, in turn, results in the lowering of overall employee expenses because of the number of benefits that are tied to base pay, 3) without the incentive compensation plan IPL's employee compensation plan would be based solely on base pay, which is a fixed and recurring cost that would be greater than current levels, and 4) incentive compensation makes an employee more conscious of the Company's financial condition, service and business goals, which translates to employees being more conscious of services and costs to ratepayers.

The ALJ found that the Commission's earlier decisions indicated that the Commission's primary concern was that ratepayers might pay for incentive compensation expenses that were not actually incurred when the rates were in effect. The ALJ found that the use of a tracker account would address this concern.

The ALJ also found that if Alliant did not generate reasonable earnings per share it would increase the costs for IPL to obtain capital, due to IPL's reliance on Alliant for its equity needs.

For the above reasons, the ALJ concluded that the Company's incentive compensation plan costs were legitimate and reasonable. The ALJ recommended that the Company be able to recover these costs but that such recovery should be based on a five year rolling average, subject to a true-up mechanism to protect ratepayers from being overcharged.

3. Commission Action

The Commission will disallow recovery of the incentive compensation plan costs requested by the Company because it is not just and reasonable to assess such costs to ratepayers when they are linked to the parent Company's earnings and are largely unrelated to the operation and performance of the electric utility. This decision is in keeping with past decisions of this Commission where the Commission has consistently disallowed recovery of incentive compensation plans linked to a company's stock price or earnings per share.

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[32] *In the Matter of the Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota,* Docket No. E-002/GR-92-1185, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (September 29,1993), and ORDER AFTER RECONSIDERATION (January 14, 1994).

In this case, the payout from the incentive plan has little to do with IPL and more to do with the overall earnings at Alliant, IPL's parent company. It is not reasonable to expect ratepayers to pay for this benefit when it is largely unrelated to the operation and performance of the utility. Rather, maximizing the earnings per share of the parent company increases shareholder wealth at the expense of the ratepayer. This goal is inconsistent with the ratepayer's goal of receiving quality service at the lowest possible cost.

Under the current plan, an IPL employee's performance, even if all IPL performance goals were met, would be irrelevant to triggering incentive compensation if the parent company's earnings did not meet a specified earnings threshold. Because of this, this incentive compensation plan would not act to encourage employees to consider what may be best for IPL, but rather would encourage employees to make decisions based on short term profit goals of the parent company, without necessarily considering long-term goals of IPL.

The Company suggested that a potential benefit from this incentive compensation plan's tie-in to its parent company's earnings was related to the IPL's cost of obtaining capital. However, the Commission recognizes that there are many factors that enter into the determination of cost of capital to a subsidiary from its parent company and the link here is far too tenuous to cause the Commission to reverse its long standing, well conceived policy on this incentive plan design. Similarly, the Commission has no disagreement that there are benefits to an incentive compensation plan, but it is the specific design of this plan that causes its costs to be disallowed.

Finally, the decision herein to disallow recovery of the incentive compensation plan costs is consistent with past decisions of the Commission on the same issue. The IPL incentive plan is the same, in relevant parts, to the plan the Commission considered in NSP's 1991 rate case. In that case, the Commission disallowed recovery for an incentive compensation plan that provided for incentive payments only when the company as a whole met earnings per share targets. The Commission concluded:

> ... that NSP's incentive compensation plan is an improper effort by the Company to pass the risk of operations from shareholders to ratepayers and employees. This program is an attempt to maximize shareholders' benefits at the expense of ratepayers. The Commission will exclude all test year compensation costs.

In the Matter of the Application of the of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota, Docket No. E-002/GR-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991), at 56.

In the NSP 1992 electric rate case, where the NSP management incentive plan had an earnings per share requirement, the Commission stated:

> ...it continued to consider earnings per share thresholds an improper transfer of risk, since ratepayers bear the risks (the cost of incentive compensation) and shareholders reap the benefits (increased earnings per share.)"

In the Matter of the Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota, Docket No. E-002/GR-92-1185, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (September 29,1993), at 28.

On reconsideration the Commission did allow the plan, with modifications. However, the modifications did not negate the Commission's decision that would deny recovery for incentive plans with earnings-per-share goals. Rather, since the Company had indicated that it was not seeking recovery of amounts attributable to meeting the earnings-per-share goal, the recovery the Commission allowed did not indicate concurrence in the plans' earnings-per-share design. Therefore, the Commission does not read the 1992 case Order as diminishing the Commission's concerns about linking incentive compensation to company earnings.

On reconsideration, the Commission also addressed the Company's retaining the right not to make payments under the plan. The Commission stated:

> In the original Order, the Commission expressed strong disapproval of the Company's retention of the right not to make incentive payments earned under the plan. The Commission continues to view this as an inappropriate transfer of risk from shareholders to ratepayers and as inconsistent with the test year concept on which rates are based. The Commission will therefore require the Company to record all earned but unpaid incentive compensation recoverable in rates under this Order for future return to ratepayers. This will adequately protect ratepayers' interests and prevent erosion of the test year concept.

In the Matter of the Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota, Docket No. E-002/GR-92-1185, ORDER AFTER RECONSIDERATION (January 14, 1994), at 7.

IPL proposed a similar procedure in the current case. IPL's proposal requiring a future return to ratepayers will protect ratepayers' interests in the situation where the Company does not make incentive payments but recovery has been allowed. However, it does not address the issue of the incentive payments that require meeting an earnings-per-share threshold. It is this impermissible tie-in with the earnings-per-share of the parent company that requires the disallowance of recovery herein.

For all these reasons, the Commission will disallow recovery of the costs of the Company's Incentive Compensation Plan, thus reducing test year expenses by $339,685.

C. OPEB and Pension Expenses

1. Positions of the Parties

a. IPL

IPL adjusted the 2002 test year data to increase costs by $460,798 for other post- employment benefit (OPEB) and pension costs. This reflects costs incurred in 2003 as a known and measurable expense. IPL explained that this expense was higher than in other years due to: 1)poor investment returns as a result of weak financial markets, 2) lower interest rates, and 3) increasing medical costs for OPEB. None of these conditions were under IPL's control.

In response to the DOC's recommendation that IPL's $460,798 for OPEB and pension costs be levelized over five years, the Company argued that if the current rates were to remain in effect for five years, the DOC's proposal would deserve consideration. However, IPL argued that since the Company will be filing a rate case as soon as a 550MW power plant currently under construction goes on line in June 2004, the 2003 expenses would be included in rates only for one year. Consequently, under the DOC's proposal, IPL would under-recover its actual expenses by $369,000.

Further, IPL argued that even if it did not file a rate case in 2004, to the extent that IPL were to over-recover its actual OPEB and pension costs, the excess recovery would be paid into the OPEB and pension accounts and result in lower costs in a future rate proceeding.

b. DOC

The DOC recommended averaging IPL's proposed adjustment over five years. Doing so would result in a test year adjustment of $92,160 (one-fifth of the Company's test year proposal) and would be a downward adjustment of $368,638 to the Company's proposal.

The DOC indicated its recommendation was based on a review of the Company's OPEB and pension costs over the past five years and the recognition that the Company's 2003 projections were based on the highest point for these charges in the last five years. Further, since the Company's projected OPEB and pension costs for 2004 were $104,000 lower than for 2003, the DOC argued that this demonstrated the need to levelize the proposed adjustment to prevent future ratepayers from paying unreasonable OPEB and pension costs.

Further, the DOC argued that IPL acknowledged that the DOC's recommendation would be acceptable except for the fact that it will be filing another rate case in 2004. The Company argued that because it plans to file a new rate case, the levelization of these costs over five years would not enable the Company to fully recover its OPEB and pension costs. The DOC argued that IPL's filing of another rate case is speculative and completely under the Company's control. It argued that it is inappropriate to reject a cost recovery method that would otherwise be appropriate based on the possibility of a future rate case filing.

2. The ALJ's Recommendation

The ALJ recommended that IPL's actual 2003 OPEB and pension expenses be included in its rates. The ALJ found that the Company's proposal comes closer to matching rates with likely future expenses than the DOC's proposal.

Further, the ALJ found that any overpayment by ratepayers would have the effect of lowering future OPEB and pension expenses because any excess funds would be put in the OPEB and pension fund. The ALJ relied on the Company's intention to file another rate case in 2004 based on the fact that the gas peaker plant is already under construction and is scheduled to go on-line in June 2004.

3. Commission Action

The Commission is in agreement with the DOC that the OPEB and pension adjustment should be averaged over five years. This is reasonable given that the adjustment proposed by the Company is based on the highest point for these charges in five years. Levelizing is standard ratemaking treatment of anomalies in test year expenses, and the possibility that the timing of the Company's next rate case may work to its disadvantage in regard to this one test year expense does not justify abandoning normal test year procedures for dollar-for-dollar recovery.

The Commission finds that to rely on the Company's stated intention to file another rate case in 2004 as a basis for determining the OPEB and pension cost recovery in the current rate case is not reasonable. It is the Company that will make the determination when it is appropriate for them to file another rate case. The Commission is well aware that there are many factors that may influence that decision and the Commission will not rely on the Company's speculation as to a future event.

For these reasons, the Commission will reduce the test year expense by $368,638 to levelize the costs over five years.

D. ERP Accumulated Depreciation

1. Positions of the Parties

a. IPL

The Enterprise Resource Planning (ERP) project is a state-of-the-art information technology system that provides IPL with an efficient computer system. This computer system became operational in October 2002 and was fully operational by February 2003. Because the project became operational at the end of the test year (2002), IPL adjusted the test year data to reflect the known and measurable change. This resulted in an increase in the rate base to show the ERP investment as if it were in service the full year.

IPL requested that the investment included in the rate base for the ERP project be reduced by the average depreciation expense, which would reduce rate base by 6.5 months of depreciation expense. The DOC recommended that an end of test- year approach should be used. This would reduce rate base by 13 months of depreciation expense and increase the Company's test year depreciation reserve by $140,360.

The Company argued that it filed rate base schedules using an average rather than an end of test period rate base. In keeping with using the average rate base, it would be appropriate for IPL to also use an average accumulated depreciation, rather than an end of test period accumulated depreciation. IPL argued that the DOC's proposal singles out ERP for different treatment than all other investments and does not match the average rate base to the average depreciation reserve.

Further, the Company argued that the DOC's methodology does not reflect how investments are normally treated. It argued that there was no reason to treat the Company more harshly than would have occurred had ERP been operational during the entire test year.

b. DOC

The DOC recommended that the amount of depreciation expense for the ERP project in the test year operating income be the same as the amount of the corresponding ERP accumulated depreciation reserve in the rate base.

The DOC had no objection to IPL including in the test year rate base the entire investment in the ERP project, which would be the balance as of February 28, 2003. Also, the DOC did not object to IPL including in the test year a full year of depreciation expense related to the ERP project.

The DOC opposed IPL's proposed adjustment to depreciation reserve. The Company's proposal would include in the accumulated depreciation reserve component of the test year rate base only one-half of the full year depreciation expense amount that it proposed as test year depreciation expense. Rather, the DOC argued that the accumulated depreciation should be equal to a full year of depreciation expense.

The DOC argued that its proposal would treat the ERP plant and the reserve similarly, both on a year-end basis. The DOC argued that its proposal includes the entire ERP plant investment in the rate base, a full year of ERP depreciation in the income statement, and a full year of ERP depreciation in the reserve.

2. ALJ's Recommendation

The ALJ concluded that 6.5 months of accumulated depreciation reserve for the ERP project should be used to set IPL's rates. The ALJ found that the DOC's proposal to reduce rate base by the sum of 13 months of depreciation expense, rather than the 6.5 month average, treats ERP differently than other investments.

3. Commission Action

The Commission agrees with the DOC that the test year accumulated depreciation should be increased by $140,360 to reflect a full year of depreciation on the ERP investment. This will result in a reduction in the base rate.

The Commission might have agreed with the Company's position regarding the treatment of the ERP depreciation reserve if the investment had actually been made at the start of the test period. However, that is not the situation here.

Rather, in this case, ERP became operational at the end of 2002 and the Company adjusted the 2002 test year data to reflect the known and measurable change. As a result, the entire amount of the plant investment was included in the rate base as if it were in the rate base the entire year. Further, the Company included a full year of depreciation expenses in the expenses related to the ERP project.

Consistency requires that the ERP project expenses for depreciation match the accumulated reserve for depreciation. The Company has taken an end-of-test year balance for the ERP project. Therefore, the Company should reflect a full year's depreciation in the accumulated depreciation. To do as IPL requests would be to match an end-of-test year balance for the project with average depreciation for purposes of determining accumulation depreciation. This would be an inaccurate reflection of the current situation where the asset was not in service the full year.

For the reasons stated above, the Commission finds that it is appropriate to treat the ERP plant and the reserve on a year-end basis and will so order.

E. Non-Peak Declining Block Rate

1. Positions of the Parties

a. IPL

IPL's rates currently contain a non-peak/winter declining block rate for residential and single phase farm service. IPL indicated that the declining blocks are limited to the off-peak period and apply to very high usage (over 1,000 kWh for residential and over 3,000 kWh for farm customers). It argued that absent a declining block rate, customers with high usage would pay more than their cost of service. Therefore, eliminating or reducing the rate differential contained in the declining block would result in unfair intra-class subsidies.

IPL further stated that its system is designed to meet the peak capacity needs of its customers that occur in the summer season. Therefore, there is excess capacity during off-peak periods. It argued that encouraging usage during the off-peak periods uses existing capacity and lowers the cost of energy for all users.

IPL argued that the DOC's proposal to increase the declining block rate in this rate case and to entirely eliminate the declining block in IPL's next rate case would result in a rate increase of 17% to customers (9% in this rate case and 8% in the next rate case) over the next two heating seasons. IPL stated that this would occur because it intends to file another rate case within a year. IPL argued that the proposals that the DOC made to mitigate rate impact would not provide adequate relief.

Finally, IPL argued that whether its off-peak declining block rates should be eliminated was disputed in the Company's last rate case. In that case the Commission approved IPL's rate for non-peak declining blocks "...in order to be fair to high usage customers, to align costs and rates more accurately, and to recognize in rates the benefits high load factors bring to the system as a whole...."[33]

b. DOC

The DOC recommended that the Commission either eliminate the declining block rate or reduce the rate differential by approximately 50%. The DOC argued that the declining block rate was not cost-based and adverse rate impacts from this elimination can be offset through the use of alternative rates and conservation.

The DOC based its recommendation on the following: 1) the declining block rates conflict with encouraging energy conservation, 2) the rates are not supported by meaningful cost information, and 3) the rates inappropriately assume that energy costs vary with a customer's level of consumption.

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[33] *In the Matter of a Petition by Interstate Power Company for Authority to Change its Rates for Electric Service in Minnesota,* Docket No. E-001/GR-95-601, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (April 8, 1996).

The DOC argued that IPL's declining block rate sends inaccurate price signals that costs decrease after a certain level of consumption is reached. Therefore, the link between consumption and cost is not accurately conveyed to the consumer.

The DOC argued that high-end residential users could take advantage of the Company's existing Optional Residential rate and thereby have winter bills that are on average nearly identical to the Company's proposed standard residential tariff. The DOC also argued that a rate increase could be mitigated for larger energy users and farm customers by their participation in IPL's Conservation Improvement Program (CIP).

Further, the DOC argued that the elimination of the declining block rates and the application of a flat rate instead would decrease bills for residential customers who use less than 1,000 kWh during the winter months. The same would be the case for farm customers with energy consumption up to 3,000 kWh per month during the non-summer season.

Finally, the DOC argued that the Commission historically disfavored declining block rates and had eliminated them in the Company's1992 electric rate case.[34] Although the Commission found that the declining block rate should be maintained in the 1996 IPL rate case, the DOC argued that the present case can be distinguished from the 1996 case because in the present case there are reasonable alternatives to the residential declining block rates and there are actions that can be taken by high end users to mitigate rate shock.

The DOC took exception to the ALJ's finding that the declining block rate should be adopted. The DOC argued that the ALJ focused on the potential harm to ratepayers from the elimination of the declining block rate but failed to note the benefits to ratepayers from the elimination of the rate. The DOC also argued that the ALJ's statement that declining block rates should be allowed when these rates are limited to off-peak times and they recover more than marginal costs was an overbroad policy conclusion and should not be adopted.

2. The ALJ's Recommendation

The ALJ concluded that the Company has demonstrated that it is permissible to maintain declining block rates during non-peak periods.

The ALJ found that IPL's existing non-peak declining blocks were cost based, eliminated intraclass subsidies, and avoided potentially harsh rate impacts that would result from their elimination.

The ALJ accepted the Company's arguments and found that absent a declining block rate, customers with high usage would pay more than their cost of service. Further, the ALJ found that encouraging usage during off-peak periods when there is excess capacity merely uses existing capacity and lowers the cost of energy for all users.

[34] *In the Matter of the Application of Interstate Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota*, Docket No. E-001/GR-91-605, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (June 12, 1992).

The ALJ found that if the DOC's recommendations were adopted there would be a rate increase of 17 percent within the period of two heating seasons. He found that the DOC's suggestions that rate increases could be reduced by conservation and customers' switching to alternative classes with demand charges did not consider the impact on space heating customers. Further, the DOC did not consider the Company's having to install new demand meters, the cost of which would be added to rate base. The ALJ also found that it was unreasonable to expect single-phase farm customers to take three-phase service.

3. Commission Action

The Commission agrees with the DOC that declining block rates raise serious policy issues, and Commission will eliminate them except for the residential class, for which the Commission will reduce the differential between the initial and end blocks of the non-peak declining block rates. This will reduce the impact of a potential rate increase on residential space heat users, who make up a large number of customers using declining block rates.

The primary reason the Commission will take this action is that declining block rates conflict with the statutory directive to encourage energy conservation.[35] Declining block rates prevent a customer from receiving the price signals that are necessary for the customer to make choices about the use of energy. The declining block rate sends the customer the signal that production costs decrease after the customer has reached a certain level of consumption. Since energy costs do not vary with the customer's consumption, such information does not enable the consumer to make an accurate link between consumption and cost. As the Commission stated in the 1996 Interstate electric rate case: "One of the most powerful tools for heightening conservation-consciousness is maintaining a clear link between consumption and cost." [36]

Further, the Commission concurs with the DOC that intra-class subsidies can be effectively addressed without sending anti-conservation price signals. Intra-class inequities can be minimized by the use of differing rate designs that reflect the different usage patterns of customers within a class. In this case, for example, many high energy use residential customers could be included in the Company's Optional Residential rate design, which recovers costs in a manner that more accurately reflects the customer's pattern of usage. This would result in a customer bill to these high energy users that was comparable to that under the declining block rate and result in intra-class inequities within the Standard Residential tariff being reduced.

Moreover, eliminating declining block rates can provide affirmative ratepayer benefits. These include lower rates to residential customers whose monthly consumption is less than 1,000 kWh and to farm customers whose monthly consumption is less than 3,000 kWh. Further, there are other programs of the Company, such as the Company's CIP programs, that may be used by residential and farm customers as a way to mitigate any rate increases.

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[35] Minn. Stat. § 216B.03.

[36] See Footnote 33, supra.

The Commission also concurs with the DOC that the use of declining block rates, which the Company stated encourages usage during off-peak periods, may not necessarily lower the cost of energy for all users. Increases in the use of the system in a non-peak period may increase total costs if more expensive electric sources are used to meet the demand.

Finally, the Commission's decision here is in keeping with past decisions disapproving declining block rates. While the Commission has sometimes found that rate affordability overrode the Commission's other concerns, that is not the situation here. Here there are reasonable rate alternatives to the existing declining block rates and there are Company programs available to mitigate the impact of any possible rate increase. For these reasons, the Commission will move toward the elimination of declining block rates, which it finds conflict with encouraging energy conservation, an important state policy goal.

For the reasons discussed above the Commission will adopt an alternative residential declining block rate in which the end block energy rate is set at 60% of the price of the first energy block and eliminate the declining block for single-phase farm service. The Commission will so order.

F. Mandated Nuclear Study Costs

1. Background

On January 1, 2002, IPL, as a result of a merger, obtained an ownership interest in the Duane Arnold nuclear power plant (Duane Arnold) in Iowa. Prior to the merger, costs related to Duane Arnold were recovered from Iowa ratepayers. After the merger, Minnesota's allocated share of the plant's costs was approximately 6%.

Before the merger, in the period between 1994 and 1998, the Nuclear Regulatory Commission (NRC) required the Duane Arnold plant to install additional safety equipment. After the equipment was installed the NRC required extensive testing to make sure the additional equipment worked. These study costs were over $16 million. The studies were begun in 1989 and completed in 1998.

In a 1993 rate case the Iowa Utilities Board (IUB) accepted the Company's proposal to capitalize the study costs and include them in rate base. However, in the Company's recent rate case, the IUB required the remaining costs to be amortized over a four-year period, with no part of the unamortized balance to be included in rate base.[37] The IUB found that the costs were more analogous to an operating expense than a capital expense and changed the recovery period from a long term to a short term one.

2. Positions of the Parties

a. IPL

IPL has included $163,896 of the costs for these studies in the rate case test year.

[37] Iowa Utilities Board Docket Nos. RPU-02-3, RPU-02-8, ARU-02-1, *Final Decision and Order* (April 14, 2003).

IPL provided alternative recommendations for recovering the regulatory study costs it incurred. It proposed that the costs could be recovered over four years as the IUB recently ordered in IPL's most current rate case, or the costs could be capitalized, included in the rate base and recovered over the remaining 11-year life of the plant.

However, IPL argued, whether the these costs are treated as capital costs or as expenses, they should be charged proportionately to Minnesota ratepayers. It argued that there is no reason to treat these costs differently than the depreciation expenses related to other plant investment.

IPL argued that there was no support for the ALJ's conclusion that all of the costs should have been previously recovered from Iowa ratepayers. If IPL were not allowed to recover these costs, IPL would have unrecoverable costs in excess of $600,000 through no fault of its own.

IPL also argued that the ALJ's conclusion ignores the IUB's 1993 decision that authorized IPL to recover these costs over the life of the asset. IPL relied on this decision and the ALJ's conclusion would punish IPL for relying on the IUB's decision.

b. DOC

The DOC recommended disallowance of the costs of the nuclear studies mandated by the NRC because all of the study costs were incurred long before Minnesota ratepayers had any interest in or benefit from the nuclear facility. The studies were initiated between 1989 and 1993 and completed between 1994 and 1998. Minnesota ratepayers did not begin receiving benefits from this facility until 2002.

The DOC disagreed with both of IPL's alternative recovery proposals. The DOC agreed with the IUB's finding in the Company's 2003 rate case that the nuclear study costs were more analogous to an operating expense rather than a capital expense. The DOC argued that the difference between the decision of the IUB to grant a four year amortization period and the decision to be made herein is that the Minnesota ratepayers did not benefit at any time in the nine years of nuclear cost studies. The Commission, the DOC argued, has previously found that ratepayers must benefit from utility expenses to share in their costs.[38]

Further, the DOC argued that a regulatory asset should not be assigned to Minnesota ratepayers when Minnesota ratepayers neither caused nor benefitted from this cost.

Finally, the DOC argued, these expenses should have been recovered long before any benefits flowed to the Minnesota ratepayers. Even a four year amortization of these expenses at the culmination of the studies (ending between 1994 and 1998) would have recovered all costs before Minnesota ratepayers began receiving benefits from the facility. Any recovery from Minnesota ratepayers would be unjust.

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[38] See *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, Docket No. E-002/GR-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991).

3. The ALJ's Recommendation

The ALJ agreed with the DOC that these costs were more appropriately operating expenses than capital expenses. The ALJ found that these costs have not benefitted Minnesota ratepayers and it was not reasonable to assess Minnesota ratepayers any share of these costs. He found that had the study costs been treated as operating expenses in 1993, the costs would have already been recovered from the ratepayers who benefitted from the studies. The recovery would have been completed well before the merger that brought these costs to the Minnesota jurisdiction.

4. Commission Action

The Commission agrees with the DOC and the ALJ that any recovery of the nuclear regulatory study costs from Minnesota ratepayers would be unjust. Minnesota ratepayers received no benefit from studies done well before the time Minnesota ratepayers had any connection to the nuclear facility.

Although there is a question whether these expenses should be classified as operating or capital expenses, under either classification Minnesota ratepayers should not have to share in these costs because Minnesota ratepayers received no benefit from these costs.

The Commission accepts and adopts the findings, reasoning, and recommendations of the ALJ on this issue. If these had been properly classified as operating expenses, these expenses should have been recovered when the costs were last incurred, well before the start of benefits flowing to Minnesota ratepayers. Further, had this been done, the costs would have been recovered from the ratepayers who benefitted. When there is no link to a benefit to Minnesota ratepayers or any support that Minnesota ratepayers caused this cost, it is not reasonable to assess Minnesota ratepayers any share of these costs.

For these reasons, the Commission will reduce test year costs by $163,896 to exclude the regulatory study costs.

VII. Overall Financial Schedules

A. Gross Revenue Deficiency

The above Commission findings and conclusions result in a Minnesota jurisdictional gross revenue deficiency of $214,073 as shown below:

Rate Base	$107,728,411
Rate of Return	9.054%
Required Operating Income	$ 9,753,730
Test Year Net Operating Income	$ 9,628,219
Operating Income Deficiency	$ 125,511
Revenue Conversion Factor	1.705611
Gross Revenue Deficiency	$ 214,073

B. Rate Base Summary

Based on the above findings, the Commission concludes that the appropriate rate base for the test year is $107,728,411 as shown below:

Utility Plant in Service	$234,195,681
Less: Accumulated Depreciation	120,466,446
Net Utility Plant in Service	$113,729,235
Customer Advances for Construction	(2,973)
Construction Work in Progress	4,435,731
Accumulated Deferred Income Taxes	(11,061,129)
Customer Deposits	(164,919)
Working Capital	
Materials and Supplies	1,347,772
Fuel Inventories	1,723,938
Prepayments	214,704
Cash Working Capital	(2,493,948)
Total Rate Base	$107,728,411

C. Operating Income Summary

Based on the above findings, the Commission concludes that the appropriate Minnesota jurisdictional operating income for the test year under present rates is $9,628,219 as shown below:

Operating Revenue	
Sales of Electricity	$61,490,181
Other Operating Revenue	2,234,761
Total Operating Revenue	$63,724,942
Operating Expenses	
Production	$22,611,358
Transmission	1,439,192
Distribution	3,092,216
Customer Accounts	1,910,423
Customer Service and Sales	3,855,292
Administrative and General	4,759,029
Depreciation and Amortization	9,408,571
Income Tax	3,759,701
Taxes Other Than Income	3,495,455
Total Operating Expenses	$54,331,237
Operating Income Before AFUDC	$ 9,393,705
AFUDC	234,514
Operating Income With AFUDC	$ 9,628,219

VIII. Compliance Filing Required

The Commission will require the Company to make a compliance filing within 30 days of the date of this Order showing the final rate effects of the decisions made here and proposing a plan for refunding the difference between the amounts it collected in interim rates and the amounts it is authorized to collect in final rates. The Commission will establish a brief comment period to give interested persons a chance to review and comment on that filing.

ORDER

1. The Commission finds that the record demonstrates that Interstate Power and Light Company is entitled to increase its gross annual Minnesota jurisdictional revenues by $214,073, in order to produce total gross annual jurisdictional operating revenues of $63,939,015.
2. The Commission modifies the settlement submitted by the parties to set the Company's return on equity at 11%. In all other respects, the Commission accepts and adopts the settlement.

3. Unless otherwise explicitly noted herein, the Commission accepts, adopts, and incorporates by reference the findings, conclusions, and recommendations of the Administrative Law Judge.

4. Within 30 days of the date of this Order, unless either party rejects the Commission's modification of the settlement under Minn. Stat. § 216B.16, subd. 1 (b), the Company shall file with the Commission, for its review and approval, and shall serve on all parties to this proceeding, a compliance filing implementing the decisions made herein and containing at least the following items:

   (a) Revised schedules of rates and charges reflecting the revenue requirement and rate design decisions contained herein.
   (b) A proposed effective date for the revised rates and charges.
   (c) A schedule of Conservation Improvement Program tracker activity beginning with the December 31, 2002 balance of $2,978,699 and ending with the date that the final rates set in the proceeding go into effect.
   (d) The revised base cost of energy to be put into effect with final rates, supporting schedules, and revised fuel clause tariffs.

5. Comments on the filing required under paragraph 4 shall be filed within 30 days of the date that the Company makes its filing.

6. The Company shall set the Conservation Cost Recovery Charge included in base rates at $0.00289 per kWh and shall set the Conservation Cost Recovery Adjustment at $0.00097 per kWh.

7. The Company shall honor the terms of its agreement with the Department of Commerce, set forth on page 22 of the Administrative Law Judge's Report, to notify its customers of policy changes regarding the furnishing of meter poles and meter sockets and to report on any customer complaints or concerns expressed in response to these policy changes in its next rate case and in its 2005 and 2006 service quality filings under Minnesota Rules Chapter 7826.

8. Within 30 days of the date of this Order, unless either party rejects the Commission's modification of the settlement under Minn. Stat. § 216B.16, subd. 1 (b), the Company shall file with the Commission and shall serve on all parties a proposal for refunding the difference between amounts collected in interim rates and amounts authorized to be collected in final rates. That proposal shall include paying interest on those amounts calculated at the average prime rate.

9. The Company shall reduce the rate differential between the initial and end blocks of its non-peak declining block rates for residential customers by pricing the end block at 60% of the price of the initial block. The Company shall eliminate the declining block rate structure for farm customers.

10. Beginning with the date of this Order, the Company shall make an annual filing detailing the status of all FAS 143 regulatory assets, detailing the status of all internal nuclear decommissioning funds, and describing and explaining any significant changes or events relating to either of these issues.

11. In its next rate case, the Company shall provide detailed class cost-of-service information as set forth on page 24 of the Administrative Law Judge's Report.

12. In its next rate case, the Company shall honor the $250,000 rate case expense cap agreed to in the Stipulation and Settlement between the Company and the Department.

13. If the Company proposes to eliminate Stored Heat Service in its next rate case, it shall include in its rate case filing information on the extent to which it expects Stored Heat customers to transfer their use from off-peak periods to on-peak periods and information on the effect of those transfers on its system.

14. In future rate cases, the Company shall provide a cost-benefit analysis supporting marketing expenses for which it seeks rate recovery. That analysis shall address the concerns identified by the Department in this case.

15. In future rate cases, the Company shall use the weather normalization process set forth at pages 6 to 7 of the settlement submitted in this case.

16. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

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Dissenting Opinion of Commissioner Ken Nickolai

In the Matter of a Petition by Interstate Power and Light Company for Authority to Increase Electric Rates In Minnesota E-001/GR-03-767

I respectfully dissent from the majority's decision because I believe that expenses paid by Interstate Power related to the costs of establishing and operating the Midwest Independent System Operator (MISO Schedule 10 costs) should be included in the test year expenses and recovered. Commissioner Scott urges the expenses be denied arguing that the decision be governed by Minn. Stat. 216B.03 which says in part, "Any doubt as to reasonableness should be resolved in favor of the consumer." The Administrative Law Judge (ALJ) recommended deferring the decision until the benefits can be quantified and assessed.

There is ground for reasonable people to differ over the recovery of these expenses. This is especially true since the record contains no *quantification* of benefits to Minnesota customers. However, I am persuaded of the reasonableness of these expenses at this time. Utilities are being actively encouraged to join these regional transmission systems by the Federal Energy Regulatory Commission (FERC). In this case, as with others, membership was a stated condition of the FERC approval of a merger. The ALJ found that "FERC expects public utilities to join a Regional Transmission Organization (RTO) unless they can show good cause for not joining."[1] These organizations are assigned responsibility for grid reliability and management as well as creating a market for the wholesale transmission of electricity. MISO is in its start-up phase so it is understandable that a specific quantification of benefits is not possible. In addition, the record does indicate a range of current, non-quantifiable, benefits from MISO activities such as security coordination and seams agreements.[2]

This does not mean that I urge the Commission to automatically allow recovery of all MISO costs in future cases. When the issue arises in future cases, an analysis of the relative costs and benefits of participation in MISO will be appropriate to help inform the Commission decision on cost recovery. But during this start-up stage, when such analysis is impractical, I conclude that these costs are a reasonable expenditure by the utility as it performs its obligation to provide service to its customers under state and federal regulation.

For these reasons, I respectfully dissent.

Dated April 1, 2004

Ken Nickolai
Commissioner

[1] ALJ Finding 11.

[2] See, ALJ Findings 16, 17 and 18.